

## State of Illinois

### Presentation to the Pension Task Force on Asset Monetization and Public Pension Funds

August 26, 2009



# Overview

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Citi believes that a Muni Equity alternative for Illinois offers superior value opportunities and an ability to realize value in today's tumultuous financial markets

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- As an example, Illinois lottery is an extraordinarily valuable asset that will command substantial investor interest. As a stand-alone enterprise, it is bigger than any lottery gaming company in the world.
- Massive disruption in the credit markets prevents achieving appropriate value through a concession. Historical concession values of \$10+ billion required substantial debt and equity financing which is not available
  - Constraints on banks balance sheets and a freeze in the credit markets make a concession an “academic” evaluation
  - Recent U.S. Justice Department ruling only exacerbates lottery privatization challenges
- While the IPO market is currently very selective, in precedent turnarounds large stable cash flow businesses have lead the way in the market
  - Citi expects the IPO market to begin its rebound in late 2009
  - An IPO process would likely take 9 – 12 months to complete
- Public investors will fairly value PPP Concessions and be focused on their core investment merits
  - Stable historical cash flows
  - Regulated competition creating barriers to entry
  - Tangible growth opportunities in Illinois and nationwide
  - Scale and cash flow to appeal to investors
- Unlike with a concession, in a Muni IPO, there is residual ownership
  - Ability to realize continued upside
  - Ability to utilize stake for incremental funding source
- Muni IPO is superior to simply retaining a private manager
  - Transform lottery from agency into true business oriented enterprise
  - Pension Fund equity investors will demand maximum returns and will provide strong governance and financial discipline

# Methods to Address POB Underfunding

Illinois' Pension UAL is large by all measures and requires a comprehensive approach to satisfactorily address, e.g., increased contributions via Muni IPO, Benefit Reforms and maybe more POBs

## Increase Annual Payments to a Trust

### Pros

- Least Complicated
- If annual budget contribution equals the ARC, no balance sheet liability

## Reduce or Control Benefits

### Pros

- Reducing or limiting a portion of existing benefits can help reduce the UAL
- Private sector precedents

## Implement Favorable Actuarial Assumptions

### Pros

- Clean template from which to start for many municipalities
- Trust Fund treatment can move discount rate to 7% or 8%, similar to a pension system. This decreases the PV of unfunded liabilities

## Asset Infusion (POBs/Asset Transfers)

### Pros

- Immediate budget relief possible
- Can be used in conjunction with all other strategies
- Market gains realized on additional assets

## Continue PAYGO Funding Approach

### Pros

- No immediate negative impact on budget
- "Pre-funding" not required by GASB 45

### Cons

- Annual Payments will be substantially higher than current payments
- Contributes to Budget Stress

### Cons

- Polarization of employer/retiree interests
- May need to be used in conjunction with other options

### Cons

- Limit to how much actuaries will allow
- Aggressive assumptions may have negative rating implications

### Cons

- Confers additional permanence to pension liability
- Legislation required

### Cons

- Lack of funding means growing Net pension obligation on balance sheet
- Eventual rating consequence



# Optimizing Asset Monetization through Public Pension Funds

Canadian and Australian Pension Funds have long been investing in infrastructure and Public enterprises



- CALPERS, CalSTERS and New Jersey Division of Investment leading effort to form a new "London Group" of pension funds co-investing in infrastructure and public enterprises.
- Ontario Municipal Employees Retirement System ("OMERS") is a leader in infrastructure investment and formed and owns Borealis, one of the world's finest infrastructure funds with some \$10 billion of investments
- Andy Stern, President of SEIU and former Governor Sebelius of Kansas wrote ***"Main Street, Not Wall Street Should Fix Crumbling U.S. Infrastructure"***
  - Avoid deals "structured for short-term profits and sky-high fees."
  - "America needs a large source of stable, long-term capital to build systems of buildings, roads and power supplies needed to sustain the country...a source of capital that values infrastructure because it provides a reasonable rate of return, strengthens the overall economy and doesn't burden users with excessive fees."

# Introduction – Transforming the Illinois Lottery

## Goals:

- *Protect Education Fund from expected decline in Lottery revenues*
- *Meet funding requirement of Capital Bill*
- *Propel Lottery's value to reduce Pension Unfunded Accumulated Actuarial Liability ("UAAL")*

## Private Concession:

Employ concession-bid model to foster entrepreneurship, innovation and performance incentives generating higher lottery earnings and value

- Private Concessionaire increases revenues pursuant to Concession and Lottery Board Rules
- Proceeds are allocated to capital program and education
- Share of ongoing lottery earnings continue to flow to State
- U.S. Justice Department has ruled private lotteries illegal requiring new federal legislation
- Massive credit market disruption prevents achieving fair value

## Public Alternative:

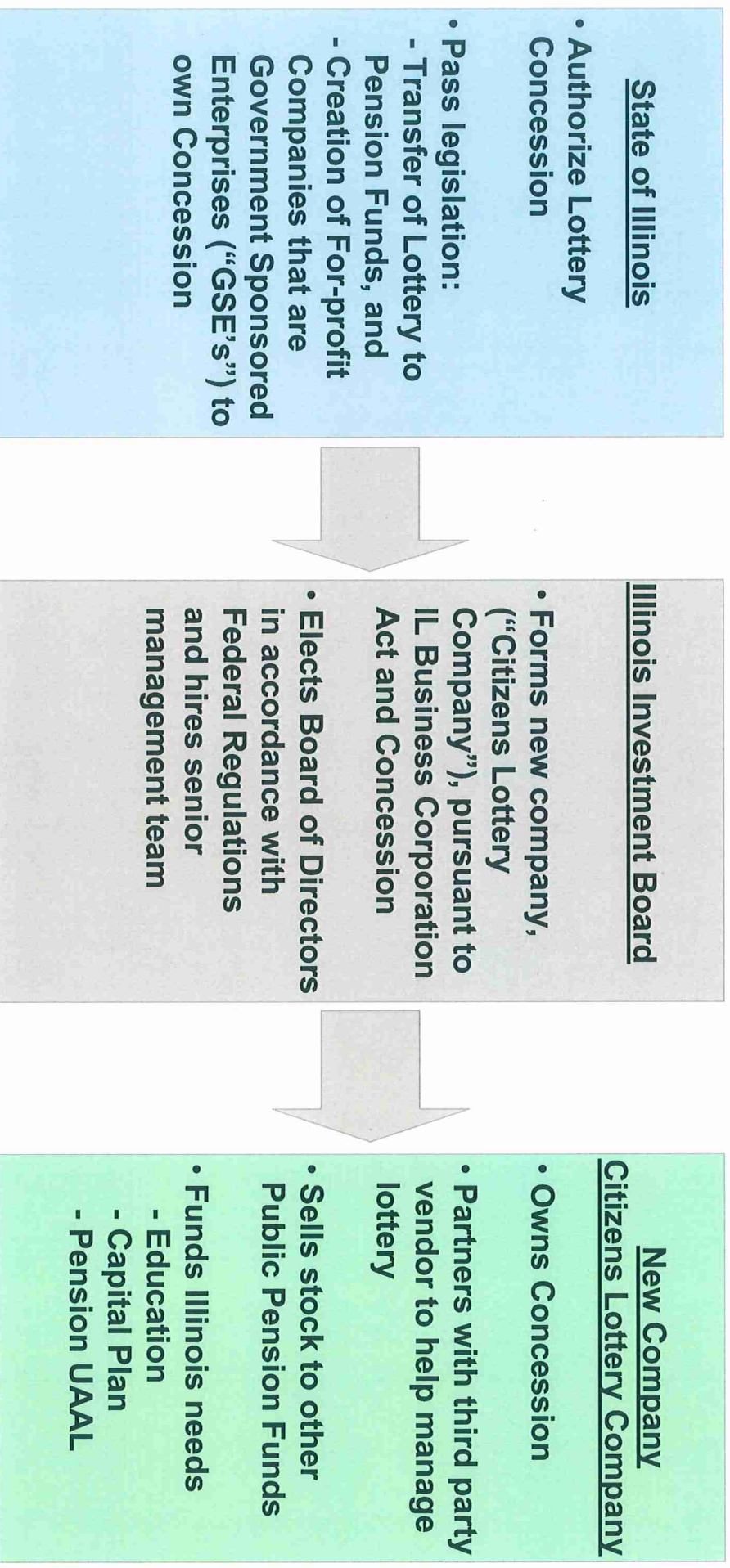
Establish new for-profit company ("Citizens Lottery Company") owned by Illinois Pension Funds to operate Concession and to provide even greater value

- Concession model efficiencies are employed by partnering with Private Lottery manager to increase revenues
- Citizens Lottery Company would be owned by Illinois Pension Systems and would be a "national company"
- Company will sell shares to Public Pension Funds to raise funds, validate stock value and assure strong, independent governance
- Illinois Education Fund receives annuity credit of \$600 million – No Cliff
- Capital Project Funds get approximately \$150 million p.a. for 25 years



# Introduction – Three Basic Steps Simplified

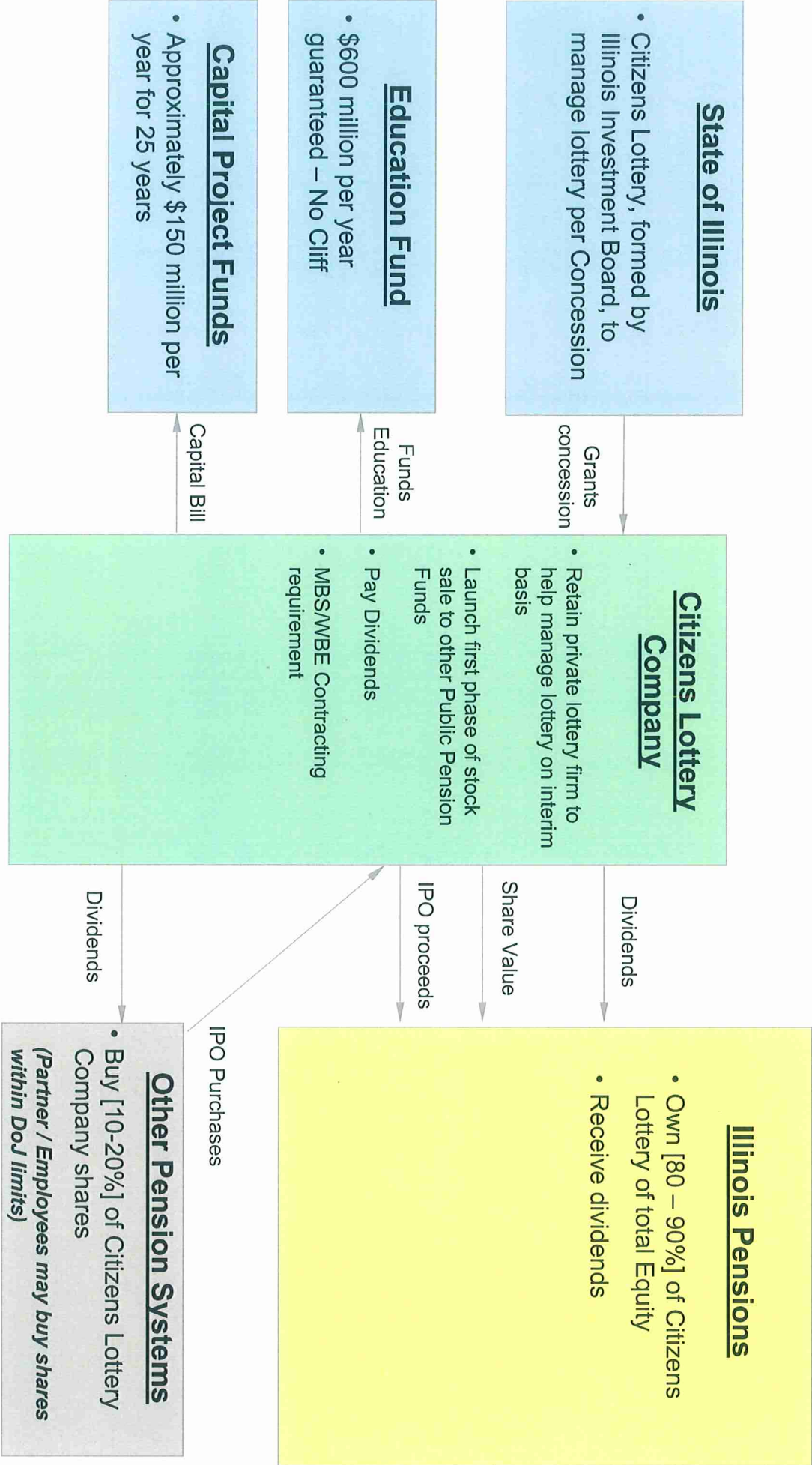
The Lottery concession will be in the hands of a Pension Fund-owned company directed by Independent Board subject to the highest standards of governance



Note: Similar strategy may be employed to monetize concession value of the Illinois Tollway

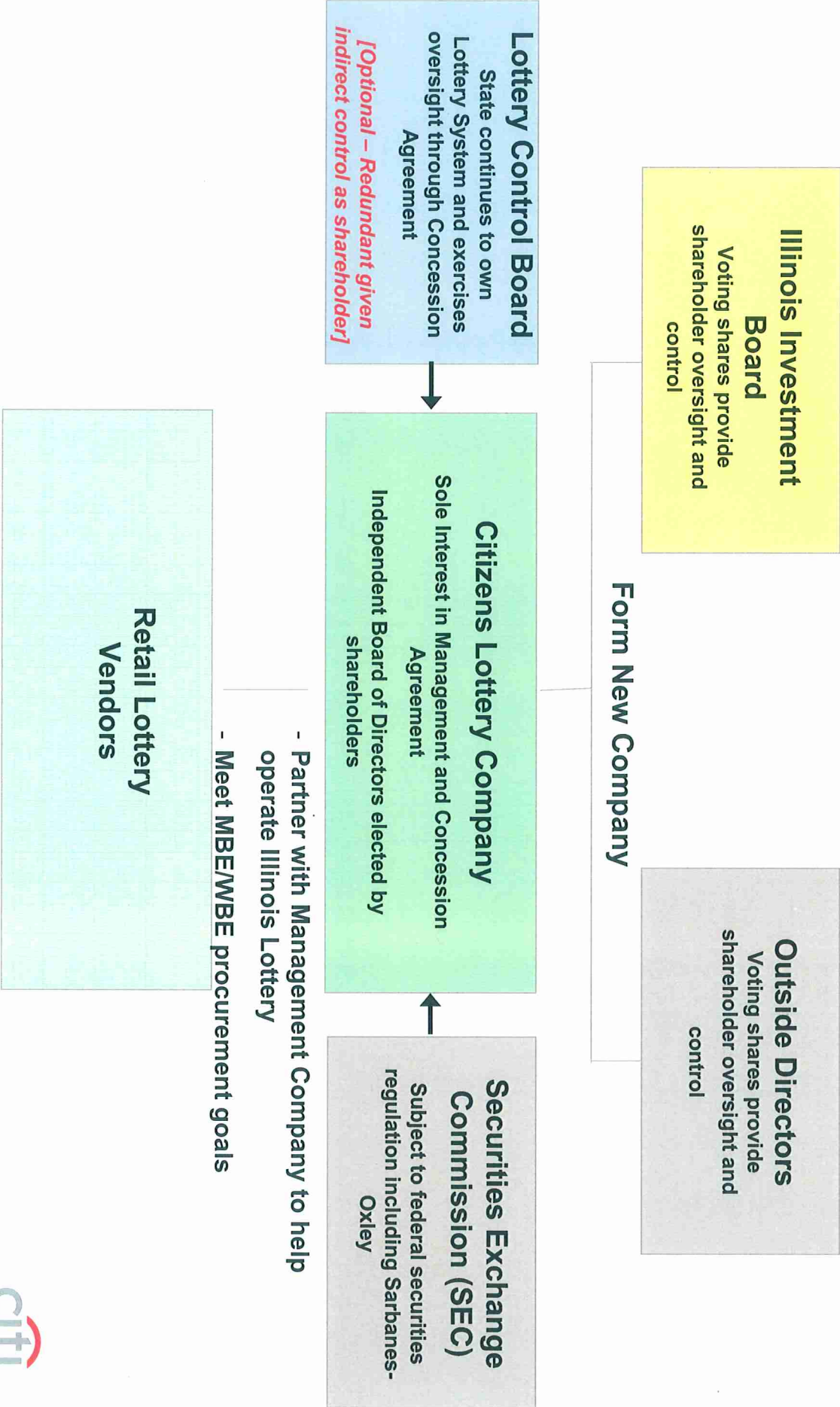
# Citizens Lottery Company – Master Layout

This Lottery Concession Plan will meet the State's goals, address U.S. Justice Department concerns and deliver substantial added value to Illinois



# Diagram of Citizens Lottery Company Start-up

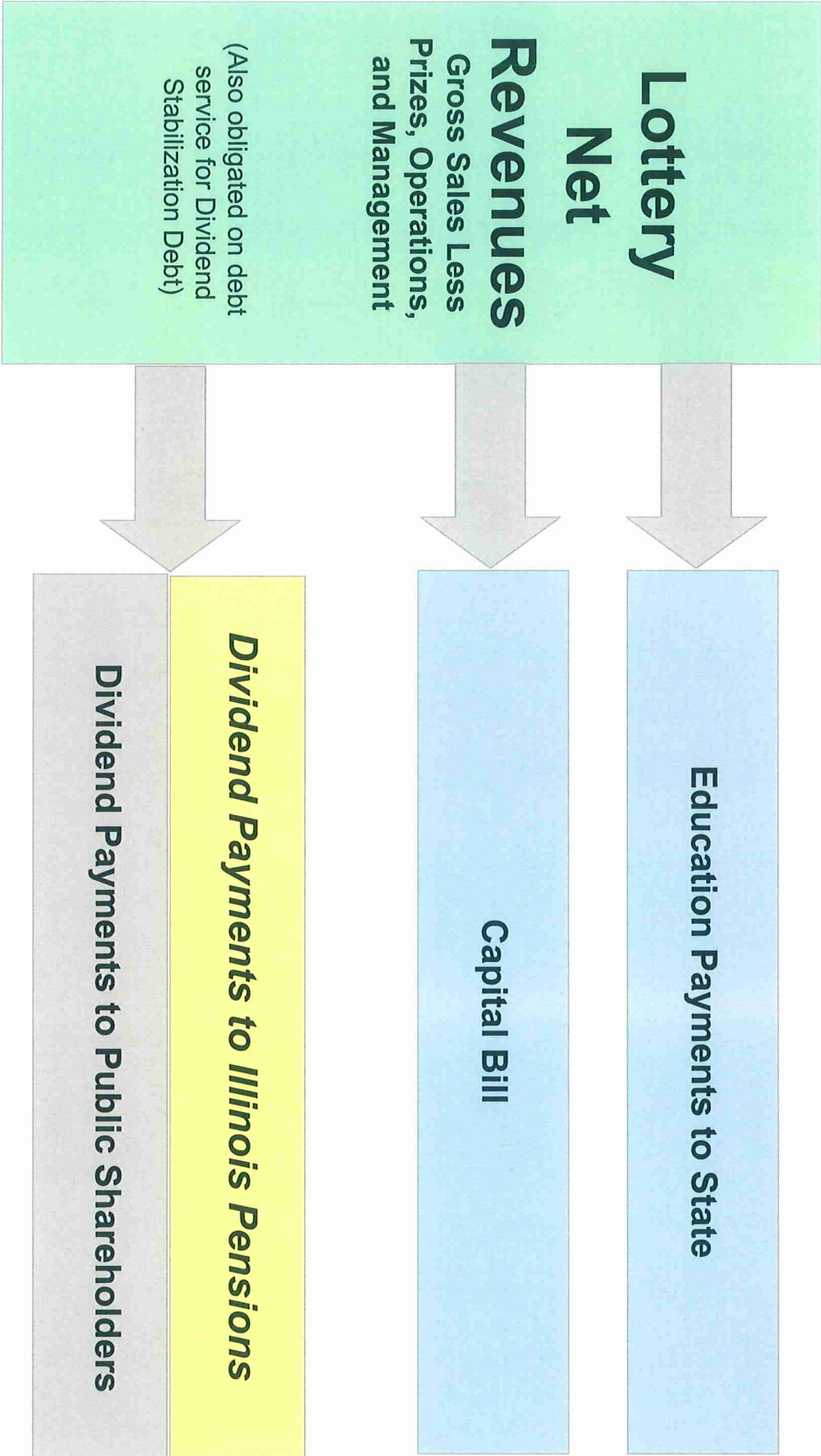
Citizens Lottery Company will be governed by independent directors and subject to SEC oversight, safeguarding the State's interests





# Cash Flow for Citizens Lottery Company

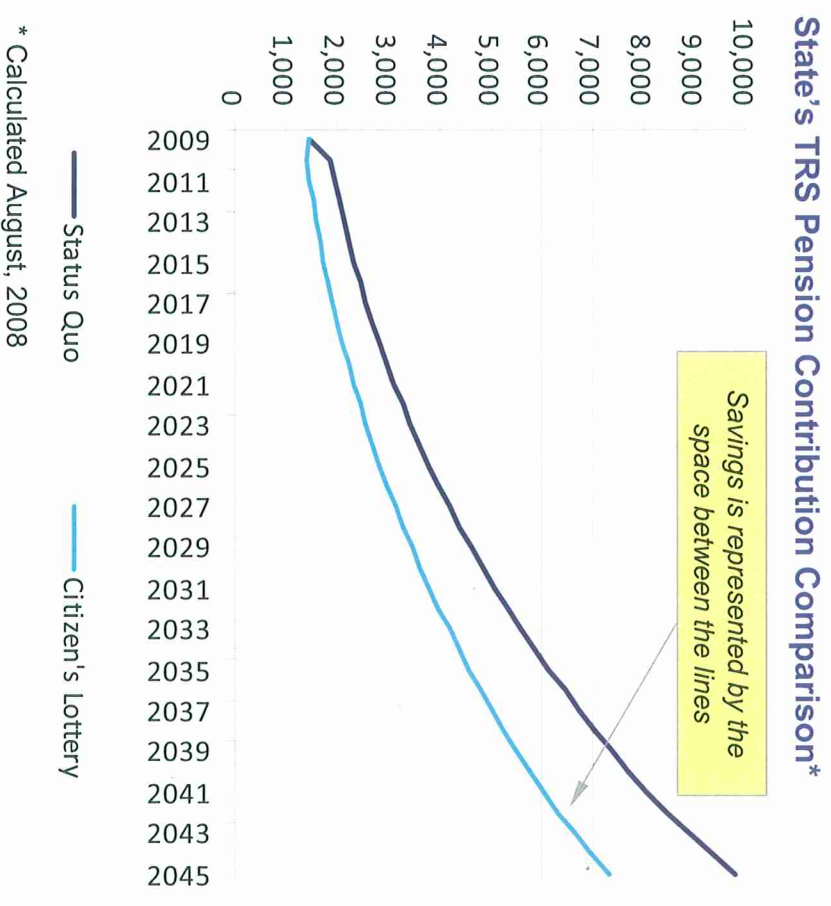
Free cash flow for the Citizens Lottery Company will be similar to private concession and Illinois Pension Funds as holders of the Company's equity will benefit from significant income and value



# Pension Fund Monetization – Reduce State TRS Contributions

Because the Citizens Lottery Company provides new cash flow deposits to the Pension System, the State's planned contributions could be reduced

- For this discussion, consider the Citizens Lottery Company as an asset owned specifically by the Teachers Retirement System (TRS)
  - Prior to IPO, Citizens would be valued based on independent Fair Market Appraisal and afterwards based on share price
  - The TRS would receive the estimated proceeds of the IPO and a share of the subsequent dividends paid by the Company
- Although Citizens shares will likely exceed TRS investment concentration and diversification rules, such shares are being accepted in lieu of cash pursuant to a new state statute
  - Can sell shares in future
  - Can leverage Citizens Co. to transfer risk to bondholders
- The graph at right shows the results of Citi's analysis
  - All forecasts assume that contributions are a constant percent of payroll
  - The reduced rate is implemented in FY2010
  - The dark blue line is the Status Quo
  - The light blue line is the contributions needed assuming the receipt of IPO proceeds and dividends



# Why Would Investors Want to Own the Lottery?

The lottery has a compelling investment thesis, that will resonate well with investors in the current volatile markets.

Stable Historical Cash Flows	<ul style="list-style-type: none"><li>• Lotteries are characterized by infrastructure-like qualities with stable earnings growth</li><li>• Unlike other forms of gaming, lotteries have proven to be more recession resistant</li></ul>								
	<table><tr><th>Time Period</th><th>Annual Revenue CAGR <sup>(1)</sup></th></tr><tr><td>FY07–FY08</td><td>2.8%</td></tr><tr><td>FY01–FY03</td><td>4.8%</td></tr><tr><td>FY90–FY92</td><td>1.8%</td></tr></table>	Time Period	Annual Revenue CAGR <sup>(1)</sup>	FY07–FY08	2.8%	FY01–FY03	4.8%	FY90–FY92	1.8%
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Regulated Competition	<ul style="list-style-type: none"><li>• Exclusive holder of lottery concession in Illinois</li><li>• Nine existing casino licenses, with potential for only one additional entrant over the near-term</li><li>• Restrictions on internet lottery. Critical that internet games be included under lottery concession</li></ul>								
Tangible Growth Opportunities	<ul style="list-style-type: none"><li>• Historically most state lotteries have not been managed to optimize growth</li><li>• International lottery privatizations illustrate the ability of experienced operators to quickly improve lottery performance and generate considerable growth<ul style="list-style-type: none"><li>– Optimizing payout ratios, incentivizing sales force, and focusing on product innovation are some examples of key growth drivers</li></ul></li></ul>								
Experienced Management Team	<ul style="list-style-type: none"><li>• Management contract with an experienced lottery operator is essential for “selling” the growth story</li><li>• Need to establish sufficient incentive structure in Management Agreement to ensure alignment of interests</li></ul>								

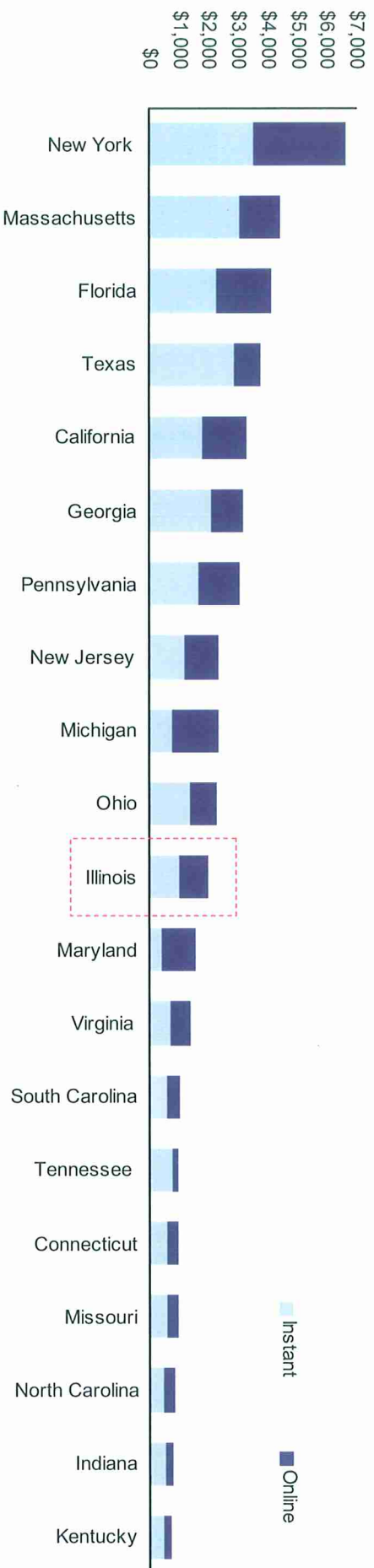
<sup>(1)</sup> LaFleurs Lottery Almanac 2008, Illinois Lottery website.



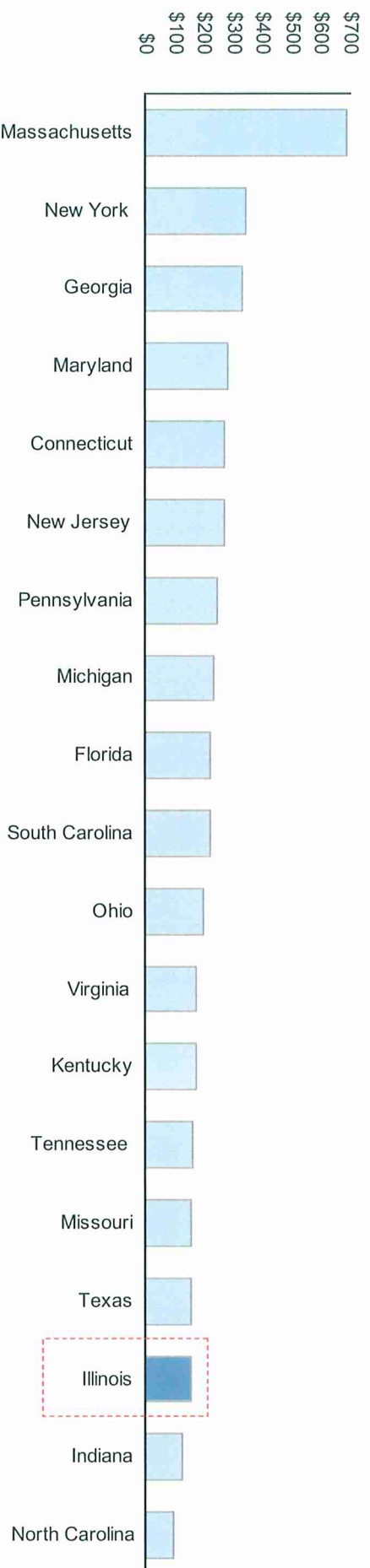
# How Does the Illinois Lottery Compare?

The Illinois Lottery is a sizable business that can benefit from a “first-mover” advantage.

Total Lottery Sales (\$ in millions)

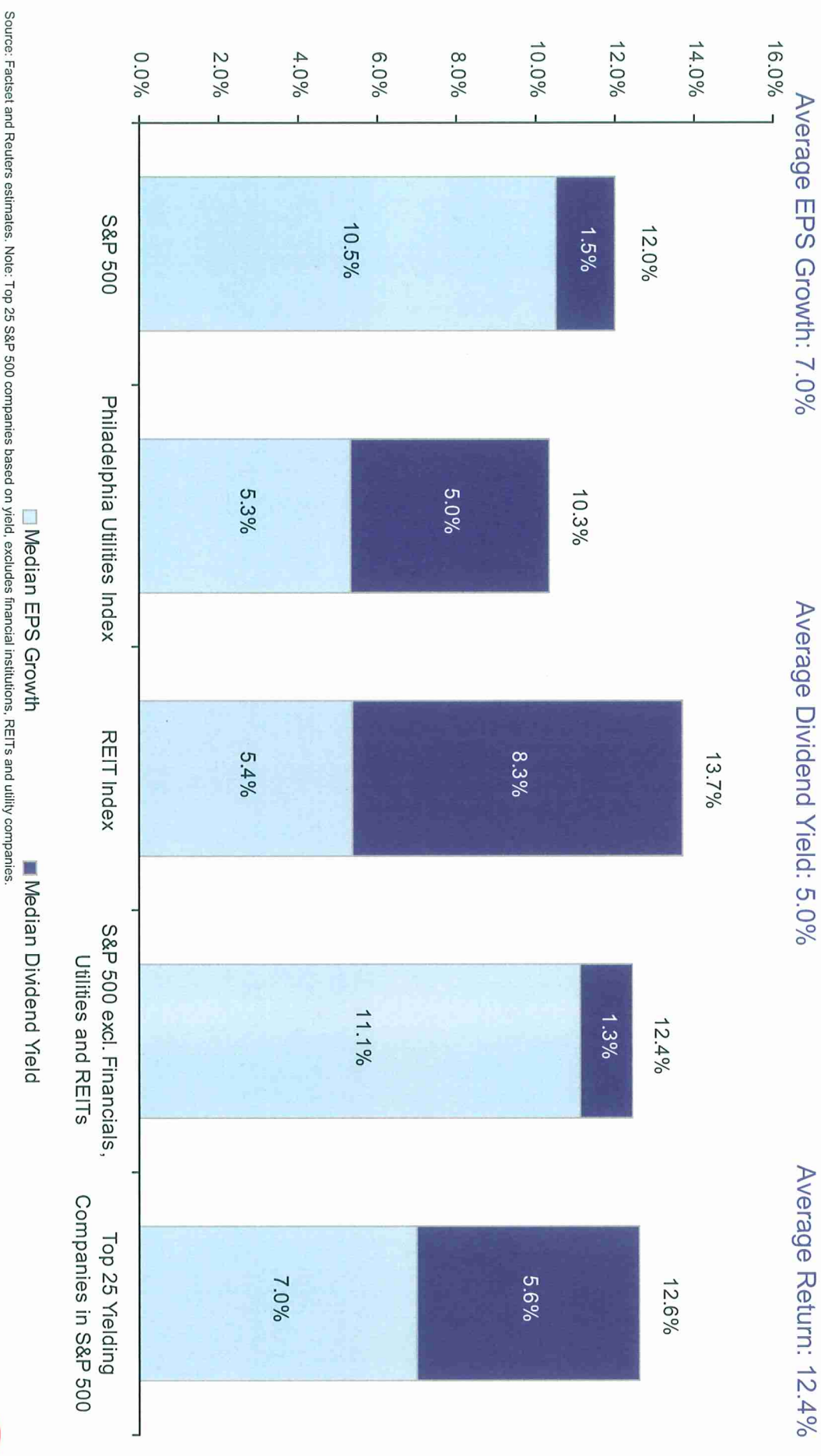


Per Capita Sales (\$ in millions)



# What Do Public Market Investors Look for In Investments?

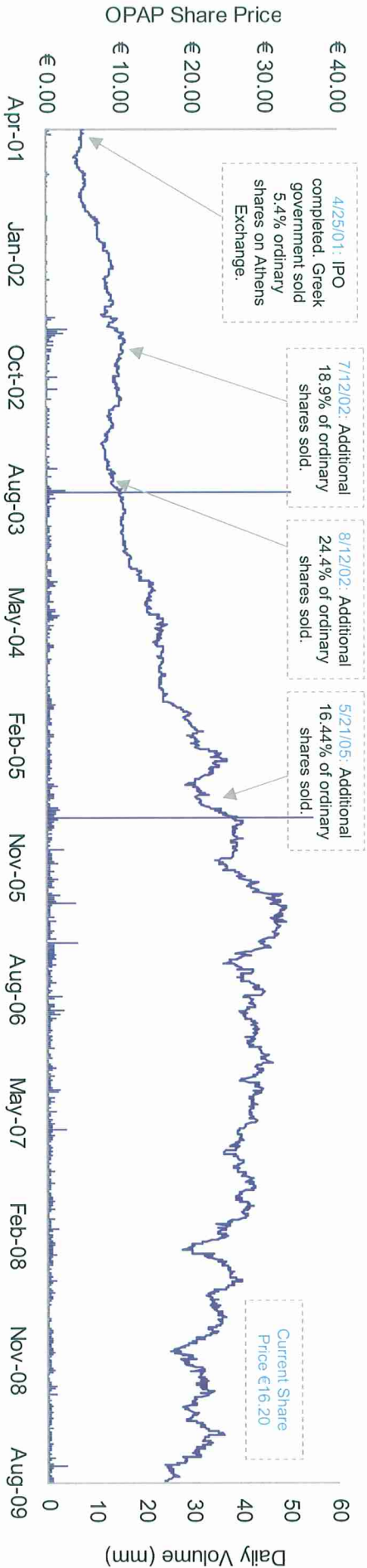
U.S. investors are focused on total return.



# OPAP has Performed Exceptionally since its IPO

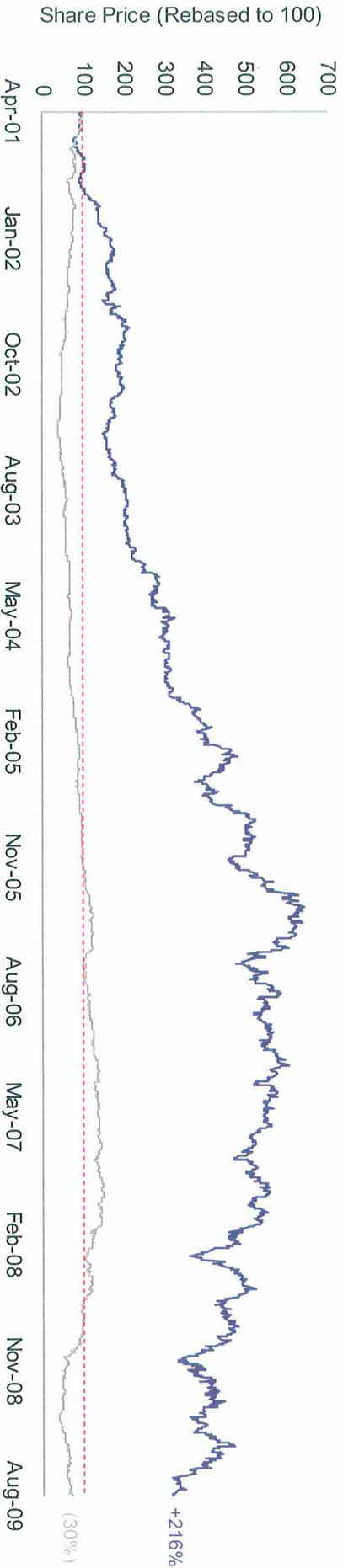
The Greek Government has been highly successful in privatizing its lottery and realizing attractive returns over time.

## OPAP Historical Trading Summary



## Relative Share Price Performance

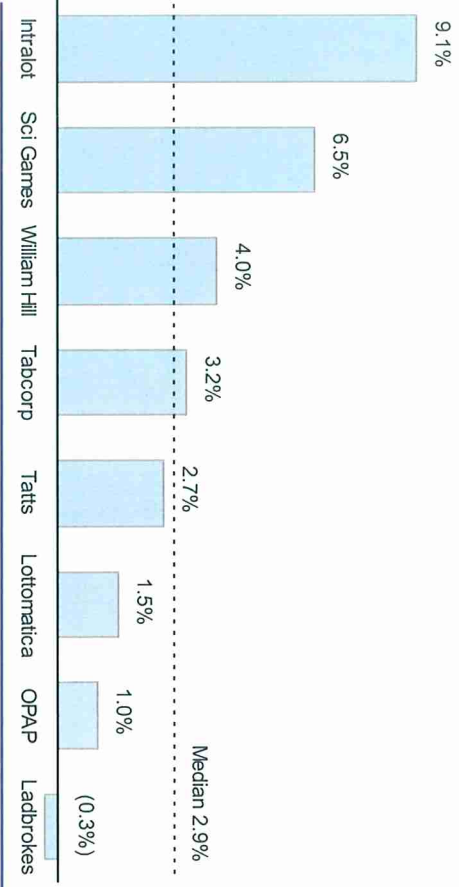
OPAP Share Price vs. Comparable Index



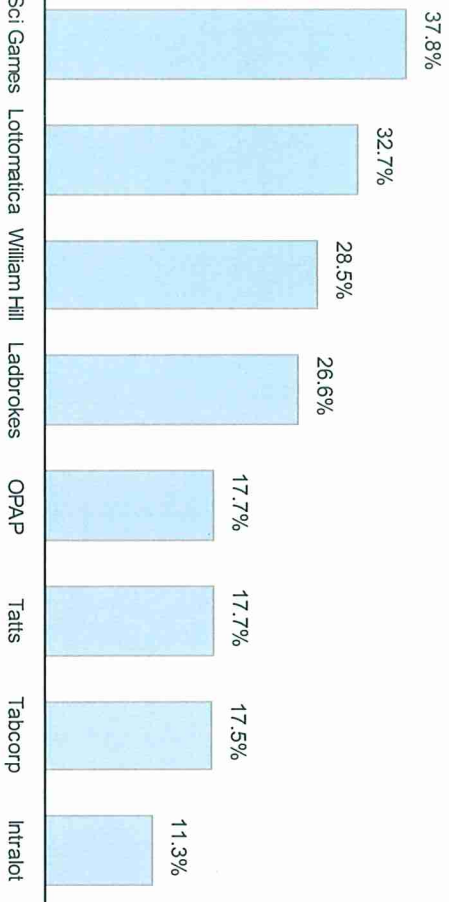


# Lottery Operational Benchmarking

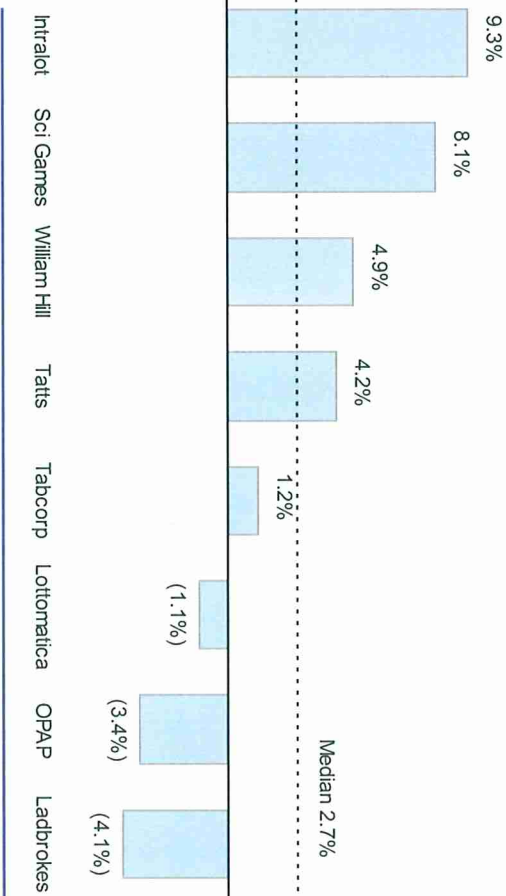
## Revenue CAGR (‘09E – ‘11E)



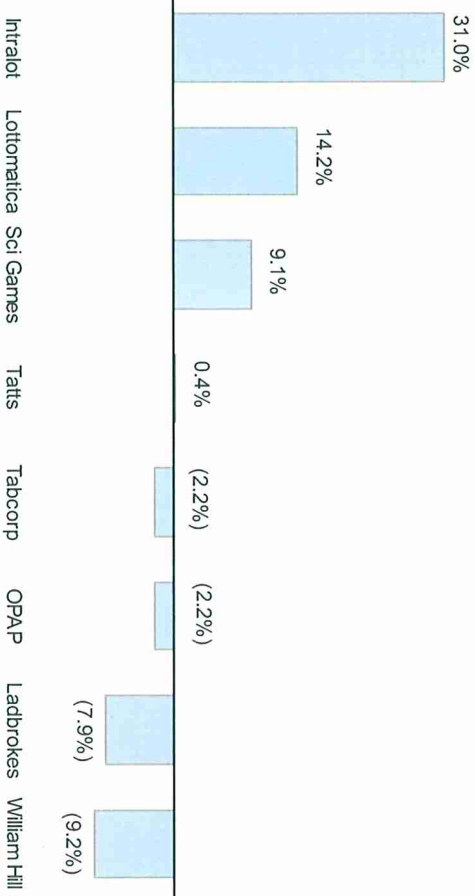
## EBITDA Margin (2009E)



## EBITDA CAGR (‘09E – ‘101E)



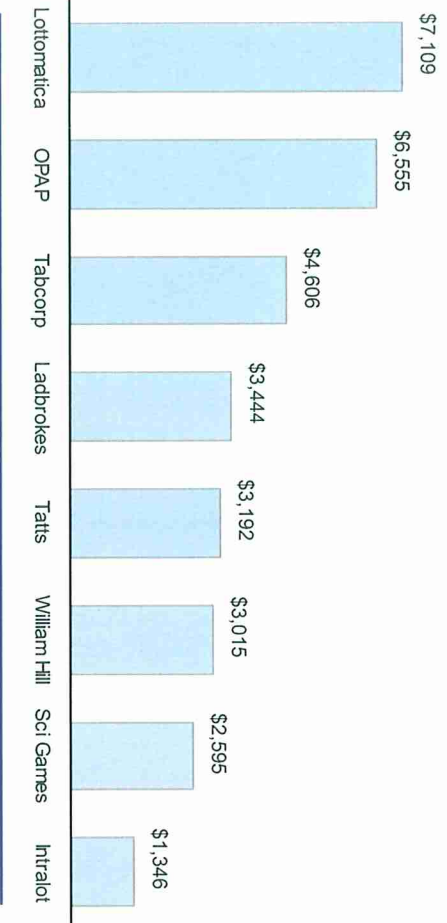
## 4 Year EPS CAGR (‘08A – ‘12E)



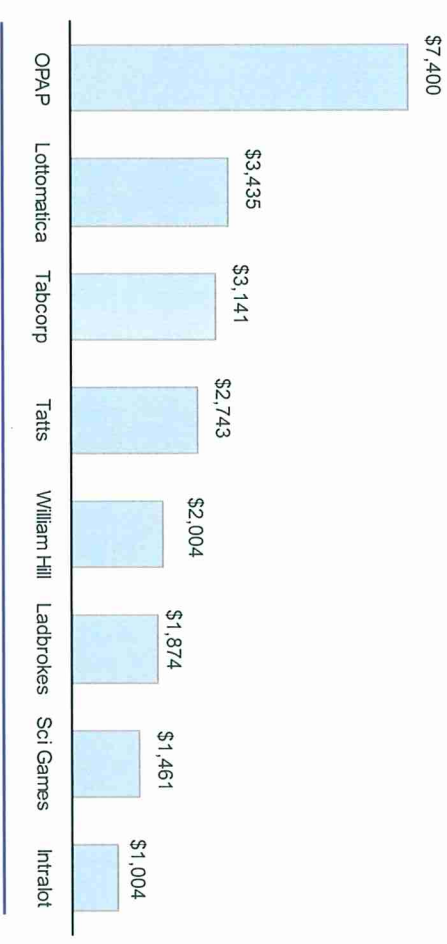
# Lottery Trading Valuations

Citi believes investors will focus on relevant trading comparables, typically valuing lottery companies on FV / EBITDA and P/E multiples. However, a focus on total return can improve multiples.

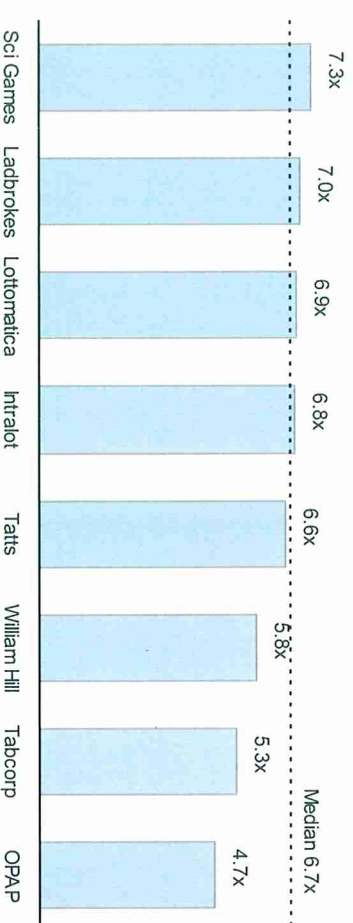
## Firm Value (US\$ mm)



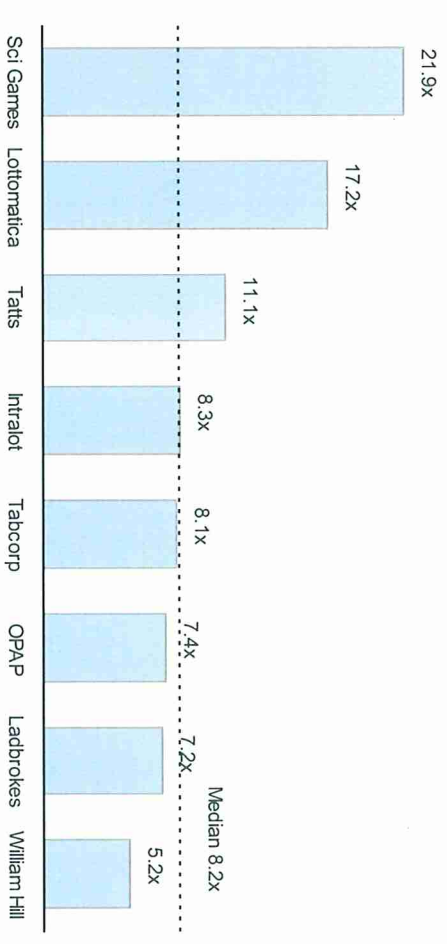
## Equity Value (US\$ mm)



## FV / 2009E EBITDA



## 2009E P/E



# citi Best-in-Class Equity Capital Markets Franchise

Citi has unrivaled domain expertise in equity underwriting and large IPOs.

## Top Equity & Equity-Linked Underwriter In Volatile Markets 2006 to Date Equity & Equity-Linked Underwriting Rankings

Rank	2008	2007	2006	2005	2004	2003
1	JPM	citi	GS	citi	MS	GS
2	GS	ML	citi	MS	GS	citi
3	citi	MS	MS	GS	citi	MS

Source: Bloomberg.

## Relevant IPO Structuring and Execution Experience

**MeadJohnson Nutrition**  
\$828 million  
Initial Public Offering  
Lead Bookrunner  
January 2009

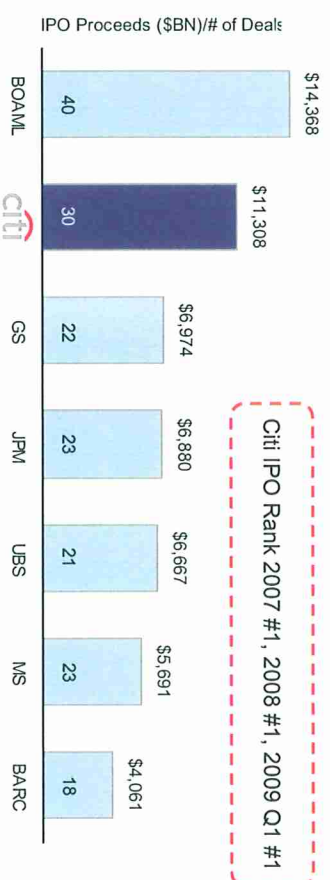
**medidata**  
Medidata Solutions Worldwide  
\$101 million  
Initial Public Offering  
Lead Bookrunner  
June 2009

**AVAGO TECHNOLOGIES**  
\$648 million  
Initial Public Offering  
Joint Bookrunner  
August 2009

- First IPO since Nov. 2008
- \$7.3 billion of demand and upsized 20%
- Institutional order book 15x over-subscribed
- Priced above initial filing range
- Largest Tech IPO since Jul. 2007
- 1<sup>st</sup> sponsor LBO IPO since IPO market re-opened

Source: Dealogic.

## Citi: The Leading IPO Underwriter Through Volatile Markets 2007 – 2009 YTD IPO Issuance



Source: Citi.

## Recent Execution Experience

**NEWMONT**  
The Gold King  
\$1,794 million  
Follow-On & Convertible  
Lead Bookrunner  
January 2009

**Johnson Controls**  
\$853 million  
Mandatory & Convertible  
Joint Bookrunner  
March 2009

**ALCOA**  
\$1,481 million  
Follow-On & Convertible  
Joint Bookrunner  
March 2009

**DOW**  
\$2,250 million  
Follow-On  
Joint Bookrunner  
May 2009

**TEREX**  
\$637 million  
Follow-On, Convertible & Senior Notes  
Joint Bookrunner  
May 2009

**Ford**  
\$1,639 million  
Follow-On  
Lead Bookrunner  
May 2009

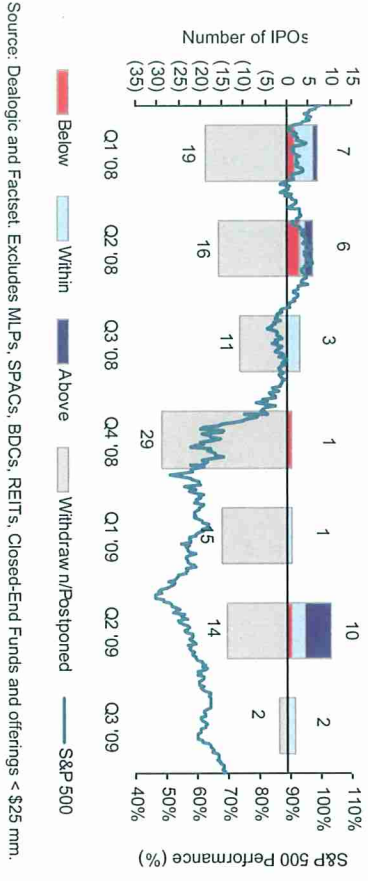
Source: Dealogic.



# IPO Market Activity Regains Equilibrium

Cash-rich investors look to deploy capital as equity market remains constructive with strong new issue receptivity. Citizens will be uniquely positioned to capture this demand.

IPO Supply / Demand Dynamics Regaining Equilibrium  
2008 to Date IPO Pricing Environment vs. S&P 500 Performance



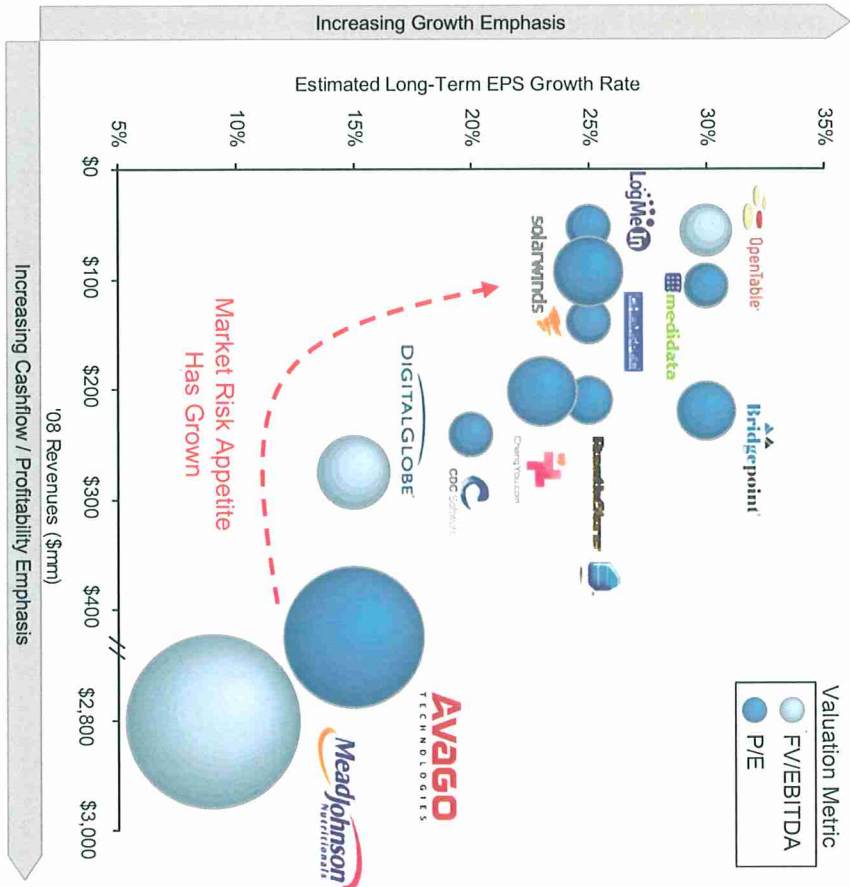
Source: Dealogic and Factset. Excludes MLPs, SPACs, BDCs, REITs, Closed-End Funds and offerings < \$25 mm.

## Strong Aftermarket Performance Draw Increased Demand 2009 YTD IPOs

Pricing Date	Issuer	Proceeds (\$mm)	% Secondary	Pricing vs. Range	% Change Offer/Current
08/05/09	CDC Software	\$58	17%	In Range	(18.8%)
08/05/09	Avago Technologies Ltd.	648	50	In Range	4.5
06/30/09	LogiMeIn Inc	107	25	In Range	10.9
06/24/09	Medidata Solutions Inc	101	0	Above	21.6
06/24/09	Duoyuan Global Water Inc	101	0	Above	99.1
06/23/09	Chemspec International Ltd	73	22	In Range	(16.7)
05/20/09	OpenTable Inc	69	48	Above	46.9
05/19/09	SolarWinds Inc	174	26	Above	65.3
05/13/09	DigitalGlobe Inc	279	91	Above	(1.4)
04/15/09	Rosetta Stone Inc	129	50	Above	60.5
04/14/09	Bridgepoint Education Inc	163	74	Below	92.5
04/01/09	Changyou.com Ltd	138	50	In Range	138.2
02/10/09	Mead Johnson Nutrition Co	828	100	In Range	66.3
13 Offerings	Mean	\$221	42%		43.8%

Source: Dealogic and Factset. Excludes MLPs, SPACs, BDCs, REITs, Closed-End Funds and offerings < \$25 mm.

IPO Has Regained Momentum With Strong Receptivity  
2009 YTD IPOs Long-Term EPS Growth vs. Revenues



Source: Bloomberg and Company filings. Size of bubble denotes market cap.

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Citi works with its clients in greenhouse gas intensive industries to evaluate emerging risks from climate change and, where appropriate, to mitigate those risks.

**efficiency, renewable energy & mitigation**

